PRIVATE SECURITIES LITIGATION/SEC Review of Safe Harbor Regulation

SUBJECT: **Private Securities Litigation Reform Act of 1995 . . . S. 240. Sarbanes/Lautenberg amendment No. 1477.**

ACTION: AMENDMENT REJECTED, 43-56

SYNOPSIS: As reported with an amendment in the nature of a substitute, S. 240, the Private Securities Litigation Reform Act, will enact changes to current private securities litigation practices in order to discourage unjust suits and to provide better information and protection from fraud for investors.

The Sarbanes amendment would strike the bill substitute's provisions on establishing a "safe harbor" from private securities actions for forward-looking statements and would substitute in lieu thereof a requirement for the Securities and Exchange Commission to study the issue and then promulgate regulations and make legislative recommendations for creating a safe harbor, if it deemed it appropriate. (The bill substitute will create a safe harbor from actions alleging that claims in forward-looking statements were fraudulent if those statements: 1) were projections, estimates, or descriptions of future events; 2) were clearly identified as such; and 3) were accompanied by a clear warning of the risk that actual results could differ materially. The safe harbor will not apply to forward-looking statements that are "knowingly made with the purpose and actual intent of misleading investors." It will also not apply to the following: 1) statements about a company which has been convicted of certain securities violations within the last 3 years; 2) statements made in an offering by a "blank check" company (a company that offers securities but has no clear business plan); 3) statements made by an issuer of penny stock; 4) statements made in connection with a rollup transaction (in which limited partnerships combine); 5) statements made in connection with a going private transaction (in which a company buys back its shares from its public shareholders); 6) statements made in connection with the sale of mutual funds; 7) statements made in connection with a tender (takeover) offer; 8) statements made in connection with certain partnership offerings and direct participation programs; 9) statements made in connection with ownership reports (such reports are required for anyone who purchases more than 5 percent of the company; reports detail the purchaser's intentions for the company); and 10) forward-looking statements in the financial statements of companies.)

(See other side)

YEAS (43)			NAYS (56)			NOT VOTING (0)	
Republicans (7 or 13%)	Democrats (36 or 78%)		Republicans (46 or 87%)		Democrats (10 or 22%)	Republicans (0)	Democrats (0)
Cohen	Akaka	Hollings	Abraham	Hatfield	Baucus		
Jeffords	Biden	Inouye	Ashcroft	Helms	Dodd		
McCain	Bingaman	Kennedy	Bennett	Hutchison	Feinstein		
Roth	Boxer	Kerry	Brown	Inhofe	Ford		
Shelby	Bradley	Kohl	Burns	Kassebaum	Johnston		
Snowe	Breaux	Lautenberg	Campbell	Kempthorne	Kerrey		
Specter	Bryan	Leahy	Chafee	Kyl	Lieberman		
	Bumpers	Levin	Coats	Lott	Moseley-Braun		
	Byrd	Mikulski	Cochran	Lugar	Murray		
	Conrad	Moynihan	Coverdell	Mack	Reid		
	Daschle	Nunn	Craig	McConnell			
	Dorgan	Pell	D'Amato	Murkowski			
	Exon	Pryor	DeWine	Nickles			
	Feingold	Robb	Dole	Packwood			
	Glenn	Rockefeller	Domenici	Pressler			
	Graham	Sarbanes	Faircloth	Santorum			
	Harkin	Simon	Frist	Simpson			
	Heflin	Wellsatone	Gorton	Smith			
			Gramm	Stevens			
			Grams	Thomas			
			Grassley	Thompson			
			Gregg	Thurmond			
			Hatch	Warner			

VOTING PRESENT(1)
Bond

EXPLANATION OF ABSENCE:
1—Official Buisiness
2—Necessarily Absent
3—Illness
4—Other

SYMBOLS:
AY—Announced Yea
AN—Announced Nay
PY—Paired Yea
PN—Paired Nay

Those favoring the amendment contended:

The substitute amendment to this bill will statutorily define a "safe harbor" from suits for forward-looking statements. The underlying bill, in contrast, will require the SEC to come up with a stronger safe harbor than currently is given to such statements. We support the bill approach, so we have offered the Sarbanes amendment to restore the bill language.

The safe harbor issue is monumentally complex. Companies need to give investors accurate predictions of their future prospects. If a company believes that it is going to introduce a new product by a certain date, for example, it should not be sued if it is delayed, and investors do not gain the profits they expected they would have if the product had been introduced on time. If companies are allowed to make good faith predictions without being unjustly accused of making fraudulent statements, everyone benefits. Thus, the idea of a "safe harbor" from suits has developed for companies' forward-looking statements. On the other hand, it should not be possible for companies to make deliberately false statements. Managers of a company should not be able to predict robust growth when they know their company is about to go bankrupt. Such managers who predict rosy futures even as they sell off their shares should be sued for fraud. Similarly, if brokers encourage investors to make risky investments by lying about the expected rates of returns, those brokers should be prosecutable. The trick is to design a safe harbor that protects honest statements but keeps out the crooks.

SEC Chairman Levitt wrote to us expressing concerns with the statutory definition in the substitute to this bill. He also explained some of the difficulties involved in devising an effective safe harbor that protects honest companies, provides investors with timely information, and protects investors from fraudulent information. Some of the questions that need to be decided include whether a safe harbor should apply to information that the SEC requires to be disclosed, whether companies should be required to update predictions when they turn out to be incorrect, and whether certain types of transactions, such as partnership offerings or going private transactions, should receive safe harbor protection. The SEC solicited comments on this issue and received 150 responses. It then held hearings, and saw more witnesses and took more testimony than the Banking Committee did on this entire bill. The SEC is now working through that incredibly complex testimony to develop a fair and workable safe harbor.

The SEC has more competence in this area than do Senators. We should wait for the expert judgment of the SEC. Senators should not simply draw up their own idea of an appropriate safe harbor because they are frustrated that it is taking the SEC a long time to come up with the right solution. Acting in haste, as our colleagues wish, may result in a standard that provides protection to fraudulent statements. We prefer to wait for the SEC to act, and thus favor the Sarbanes amendment.

Those opposing the amendment contended:

We agree that the safe harbor issue is incredibly complex; but, unlike our colleagues, we are neither obsessed nor paralyzed by this fact. Our colleagues do not deny that the present system is an utter failure; they instead say it is beyond their competence to improve it. They believe that only the SEC should act. However, we have tried for 4 years to get the SEC to suggest improvements, but to no avail. Meanwhile, both investors and companies have suffered from the current system which only benefits lawyers who delight in bringing unjust securities fraud suits. We are hopeful that the SEC will soon suggest improvements, but we are not holding our breath. Given the SEC's history of inaction, the prudent course is to enact modest legislative changes now, that will at least improve the current situation. We have accordingly included safe harbor reforms in the substitute amendment to this bill. Senators who object that the SEC is more expert in this area than are Senators are correct. However, that fact does not mean that it follows that Senators are unable to make constructive proposals. We doubt that the safe harbor reforms in this bill will prove to be perfect in practice, but we are positive that they will prove to be a vast improvement over the current failed system.

We have little reason to expect the SEC to act quickly. Four years ago, Senators began to call on the SEC to devise an effective safe harbor. The Domenici-Dodd bill, as originally drafted, was introduced 3 years ago, and it called on the SEC to act. Each version of that bill since then, until this substitute, has also called on the SEC to act. Last year's appropriations bill for the SEC ordered it to act within the year. Finally, after 4 years, the SEC held hearings a few months ago. However, we have now heard that its commissioners are in disagreement over how to construct a safe harbor. Further, the SEC is two commissioners short, and it will soon have yet another vacancy. Filling the empty seats and getting the commissioners to agree on even a draft proposal will take years. Meanwhile, companies will be put through the meat grinder by the current system, and investors will get inadequate information.

SEC Chairman Levitt, whom our colleagues have quoted in describing the complexity of the issue, also described the huge need for having a stronger safe harbor than currently exists, when he wrote the following: "The current rules have largely been a failure, and I share the disappointment of issuers that the rules have been ineffective in affording protection for forward-looking statements. Our capital markets are built on the foundation of full and fair disclosure. Analysts are paid and investors are rewarded for correctly assessing a company's prospects. The more investors know and understand management's future plans and views, the sounder the valuation is of the company's securities and the more efficient the capital allocation process. Yet, corporate America is hesitant to disclose projection and other forward-looking information because of excessive vulnerability to lawsuits if predictions ultimately are not realized." A few statistics should serve to illustrate the chilling effect that the threat of lawsuits has on companies' willingness to disclose information voluntarily. First, an April, 1994 survey found that 75 percent of the American Stock Exchange Chief

Executive Officers (CEOs) limit disclosure of forward-looking statements; second, 71 percent of more than 200 entrepreneurial companies surveyed by the National Venture Capital Association were reluctant to discuss their projected performance; third, a Harvard Business School study found that the fear of litigation is the number one obstacle to enhance voluntary disclosure by corporate managers; and fourth, according to a University of California study, less than 50 percent of companies with earnings significantly above or below analysts' projections are willing to release information voluntarily. This lack of information seriously hurts investors. Therefore, it is not surprising that the Council of Institutional Investors, which represents mutual fund investors, has called for total safe harbor protection for forward looking statements, including intentionally false statements.

This bill does not go nearly that far. Projections that are knowingly made with the actual intent of misleading investors will be actionable. Projections that are not accompanied by a clear warning that they are speculative will be actionable. Projections of transactions that are inherently more speculative, such as penny stock and blank check transactions, will not be covered. Brokers will not receive safe harbor protection, nor will mutual funds. The safe harbor in this bill is limited to forward-looking statements of a limited class of businesses, and to the statements of the auditors whom they hire.

No one is claiming that the safe harbor proposals in this bill are perfect. However, they are a clear improvement over current law. Perhaps the SEC, a few years done the line, may suggest even better proposals. Until it does, though, Senators should not allow the current failed system to stay in place. Accordingly, we urge the rejection of the Sarbanes amendment, which would retain the status quo until such time as the SEC finally gets around to acting.